Via Electronic Mail  

June 11, 2014  

Ms. Catherine Woods  
Financial Reporting Council  
Fifth Floor  
Aldwych House  
71-91 Aldwych  
London WC2B 4HN  

Dear Ms. Woods:  

I am writing on behalf of the Council of Institutional Investors (the Council) to discuss the Financial Reporting Council’s (FRC) Proposed Revisions to the U.K. Corporate Governance Code (Code) of April, 2014. The Council is an association of corporate, union, and public employee benefit plans, foundations, and endowments, with combined assets exceeding $3 trillion. As a leading voice for long-term investors, the Council welcomes the opportunity to provide its perspective and recommendations on these proposed revisions.

The FRC is to be congratulated on its continuing thoughtful and appropriate revisions to the Corporate Governance Code. These revisions, fostering as they do responsible remuneration programmes, corporate accountability, and appropriate risk management are both consistent with corporate governance best practices and are an admirable if not essential step to fostering investor confidence essential to stable and prosperous capital markets.

Our specific comments on the FRC’s proposed revisions follow as answers to the questions posed in the April 2014 Consultation Document. Because the Council has does not have policies covering each of the proposed revisions, we have limited our responses only to those revisions upon which our member-approved policies touch.

A. Executive Remuneration

**Question 1: Do you agree with the proposed changes in Section D of the Code?**

The Council strongly agrees with the FRC’s proposed revision to the language of the Main Principle for Section D.1 of the Code, making plain that executive remuneration should be tied to long-term company performance.

The Council has long “endorse[d] reasonable, appropriately structured pay-for-performance programs that reward executives for sustainable, superior performance over the long-term . . . .” Moreover, the Council’s Corporate Governance Policies direct remuneration committees to

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1 For more information about the Council of Institutional Investors and its members, please visit our website at [www.cii.org](http://www.cii.org).

2 The Council of Institutional Investors’ Corporate Governance Policies use the term compensation rather than remuneration and likewise compensation committee rather than remuneration committee. This letter treats these two terms as equivalent.

devise pay-for-performance measures rewarding “superior performance—based on measures that drive long-term value creation” and annual incentive remuneration plans that “reasonably reward superior performance that meets or exceeds . . . performance targets that reinforce long-term strategic goals.”

The Council’s consistent and wholehearted support for calibrating executive remuneration to long-term company performance stems from the axiomatic principle that rewarding executives for short-term performance encourages excessive short-term risk taking and a concomitant disregard for the long-term consequences for the company and its shareowners. The inherent instability bred by this short-termism renders compensation based on a long-term outlook imperative for good corporate governance. The Council thus heartily approves of the FRC’s revisions to make this principle abundantly clear in the Code.

Similarly, the Council agrees with the FRC’s revisions to the Supporting Principle of Section D.2, which acts to emphasise both the importance of the remuneration committee being concerned for conflicts of interest and recommends the remuneration committee chairman maintain contact with principle shareholders. As the Council has long believed, an independent and accountable remuneration committee is an essential component of responsible corporate governance. The Council believes that the surest way to minimise conflicts of interest in remuneration matters is to require that remuneration committees be composed solely of independent directors and we would prefer a revision to that effect. However, the proposed supporting principle speaks to the same concern for independence behind the Council’s Corporate Governance Policies and we agree with its adoption.

Question 2: Do you agree with the proposed changes relating to clawback arrangements?

Clawback arrangements are an “essential element of meaningful ‘pay for performance’ philosophy.” “If executives are to be rewarded for ‘hitting their numbers’—and it turns out they
failed to do so—they should not profit.”11 As such, the Council wholly agrees with the proposed changes, including the addition of Code Provision D.1.1 expressly requiring remuneration committees to consider adopting clawback arrangements in their remuneration schemes. The Council’s robust support of clawback arrangements is reflected in our member-approved Corporate Governance Policies:

The compensation committee should ensure that sufficient and appropriate mechanisms and policies (for example, bonus banks and clawback policies) are in place to recover erroneous bonus and incentive awards paid in cash, stock or any other form of remuneration to current or former executive officers, and to prevent such awards from being paid out in the first instance. Awards can be erroneous due to acts or omissions resulting in fraud, financial results that require restatement or some other cause that the committee believes warrants withholding or recovering incentive pay. Incentive-based compensation should be subject to recovery for a period of time of at least three years following discovery of the fraud or cause forming the basis for the recovery. The mechanisms and policies should be publicly disclosed.12

In a 2009 report, The Investors’ Working Group, an independent taskforce sponsored by the Council and the CFA Institute Centre for Financial Market Integrity, staunchly recommended strengthening clawback provisions, noting both their benefits and the then-weaknesses of existing United States federal standards:

Clawback policies discourage executives from taking questionable actions that temporarily lift share prices but ultimately result in financial restatements. Senior executives should be required to return unearned bonus and incentive payments that were awarded as a result of fraudulent activity, incorrectly stated financial results or some other cause. The Sarbanes-Oxley Act of 2002 required boards to go after unearned CEO income, but the Act’s language is too narrow. It applies only in cases where misconduct is proven—which occurs rarely because most cases result in settlements where charges are neither admitted nor denied—and only covers CEO and CFO compensation.13

The necessity of strong clawback policies as a core tenet of responsible corporate remuneration is evident among many prominent companies. For example, in 2011, a Council white paper reported that, in the wake of the global financial crisis, all surviving major Wall Street Banks,14 had implemented strengthened clawback policies including:

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11 Id.
12 CORPORATE GOVERNANCE POLICIES, supra note 3 at § 5.5d.
14 Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, & Wells Fargo.
Switching from a fraud-based policy (the executive must have been responsible for fraud) to a performance-based policy (clawbacks that apply to all executives in the event of a restatement, regardless of who was responsible), and requiring clawbacks if executives fail to identify material risks or operate outside the firm’s risk parameters.\(^{15}\)

As the above suggests, and Council policies reflect,\(^{16}\) a major component of a potent clawback regime is the understanding that clawbacks may be appropriate absent “exceptional circumstances or misstatement or misconduct.” Because of this, the Council also agrees with the deletion of current paragraph 7 from Schedule A.

**B. Shareowner Engagement**

**Question 3: Do you agree with the proposed change relating to AGM results? Is the intention of the proposed wording sufficiently clear?**

The Council does not have a specific position on the changes to Code Provision E.2.2 as to whether companies should announce, after a vote where a significant number of shareowners vote against a passing proposal, their intended plan to engage with shareholders to find the reason behind the opposition.

As a general matter, the Council’s policies broadly countenance greater board accountability and engagement with shareowners.\(^ {17}\) And the Council recognises the essential nature of a company’s engagement and communications with its shareowners—especially those long-term investors of “patient” capital represented by the Council. As such, the Council’s Corporate Governance Policies advocate that all companies “establish mechanisms by which shareowners with non-trivial concerns can communicate directly with all directors.”\(^ {18}\)

In line with this expansive concern for board accountability and engagement, the Council’s policies require that boards take those actions recommended in majority-vote-winning shareowner proposals.\(^ {19}\) In addition, the Council regularly corresponds with companies our members invest in when those companies fail to act on majority-vote-winning shareowner resolutions. In doing so, the Council urges these boards “to conduct a thoughtful and balanced analysis of the issues raised by any majority-vote-winning shareowner resolution,” including a review by independent directors and obtaining expert advice.\(^ {20}\)

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\(^ {16}\) CORPORATE GOVERNANCE POLICIES, supra note 3, at § 5.5d.

\(^ {17}\) See *id.* at § 1.4 (“Corporate governance structures and practices should protect and enhance a company’s accountability to its shareholders . . . .”).

\(^ {18}\) *Id.* at § 2.6b.

\(^ {19}\) *Id.* at § 2.6a (“Boards should take actions recommended in shareowner proposals that receive a majority of votes cast for and against. If shareowner approval is required for the action, the board should seek a binding vote on the action at the next shareowner meeting.”).

\(^ {20}\) E.g., Letter from Ann Yerger, Executive Director, Council of Institutional Investors, to Robert C. Nakasone, Independent Lead Director, Staples, Inc. (June 10, 2014) (on file with Council).
Question 4: Do you agree with the proposed amendments to the Schedule?

The Council agrees with several of the proposed amendments to the Schedule A. As noted in our response to Question 2, we agree with the deletion of current Schedule A, paragraph 7.

Amendments to Paragraph 1

The Council agrees with the proposed amendments to Schedule A, Paragraph 1 requiring the remuneration committee to (1) “determine an appropriate balance of immediate and deferred remuneration;” and (2) to make these Remuneration incentives “compatible with risk policies and systems.” Council Policies directly charge the board and compensation committees to find that balance by “consider[ing] the full range of pay components including structure of programs, desired mix of cash and equity awards” among other things to strike the appropriate balance of remuneration.21 Further, the compensation committee must ensure that remuneration programmes “are effective, reasonable and rational with respect to critical factors such as . . . risk consideration[. . .]”22 Because these two amendments track closely with The Council’s policies, we agree with their adoption.

Amendments to Paragraph 4

The Council agrees with the proposed amendments to Schedule A, paragraph 4 asking remuneration committees to consider requiring share ownership requirements and share holding periods for company directors. Because the Council’s own long-held policy on director equity compensation mandates that director pay be structured so it is “aligned to the long-term interests of the shareowners,”23 our policies set director ownership requirements of at least three to five times annual compensation and further countenance director compensation plans that help directors meet these ownership requirements.24 Additionally, we recommend that directors hold a “significant portion (such as 80 percent)” of their equity grants until after they retire from the board.25

C. Risk Management

Question 5: Do you agree with the changes to the Code relating to principal risks and monitoring the risk management system?

The FRC’s proposed revisions to the Code broadly align with, though are more specific than, the Council’s general policies on the board’s role in risk oversight.

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21 See CORPORATE GOVERNANCE POLICIES, supra note 3 at § 5.5 (“The compensation committee should consider the full range of pay components, including structure of programs, desired mix of cash and equity awards, goals for distribution of awards throughout the company, the relationship of executive pay to the pay of other employees, use of employment contracts and policy regarding dilution.”).  
22 Id. at § 5.1 (“It is the job of the board of directors and the compensation committee specifically to ensure that executive compensation programs are effective, reasonable and rational with respect to critical factors such as . . . risk considerations . . . .”); id. at § 2.7 (“CII policies on . . . executive compensation . . . reinforce the importance of the board’s consideration of risk factors.”).  
23 Id.at § 6.2.  
24 Id.at § 6.4b.  
25 Id.
The Council believes that the board is ultimately responsible for risk oversight. Good risk oversight does not mean abolishing reasonable risk-taking, “but to establish a robust system of internal controls to safeguard shareowner value.” To that end, the Council’s Corporate Governance Policies direct that corporate boards should (1) establish a company’s risk management philosophy and risk appetite; (2) understand and ensure risk management practices for the company; (3) regularly review risks in relation to the risk appetite; and (4) evaluate how management responds to the most significant risks. Furthermore, effective risk oversight requires both meaningful communications between the corporate board and other stakeholders as well as full disclosure to shareowners, at least annually, of “sufficient information to enable them to assess whether the board is carrying out its oversight responsibilities effectively.”

With these principles in mind, the Council agrees with the revisions to Code Provision C.2.3 (former C.2.1) requiring that the board monitor risk, review their monitoring practices, and report on this review to the shareowners.

**Code Provision C.2.3** may be improved however by adding a clause stipulating that the annual disclosures contain sufficient information for shareowners to assess whether the board is carrying out its risk-monitoring duties effectively. Though we note the required disclosures across the new Code provisions likely satisfies this benchmark, including such a clause in this provision or as a governing principle would help ensure fuller disclosure and greater board accountability to shareowners.

F. Conclusion

Thank you for the opportunity to comment on the proposed revisions. If you have any questions, please contact either me at 202-261-7088, todd@cii.org or our General Counsel Mr. Jeff Mahoney at 202-261-7088, jeff@cii.org.

Sincerely,

Todd W. Noelle
Council of Institutional Investors

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26 Letter from Justin Levis, Senior Research Associate, Council of Institutional Investors, to José Manuel Barroso, President, European Commission. (July 6, 2011) (on file with Council).
27 CORPORATE GOVERNANCE POLICIES, supra note 3, at § 2.7.
28 Id.